No. 287

In the Supreme Court of the United States

OCTOBER TERM, 1946

J. ROBERT BAZLEY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT.

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 89–102) and the dissenting opinion (R. 102–104) are reported at 4 T. C. 897. The opinion of the Circuit Court of Appeals (R. 126–136) and the dissenting opinion (R. 137–140) are reported at 155 F. 2d 237.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 16, 1946. (R. 141.) The petition for a writ of certiorari was filed on July 11, 1946, and was granted on October 14, 1946.

(R. 142.) The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

Pursuant to a plan of readjustment of corporate structure, the taxpayer-stockholder surrendered his stock and received five new shares of stock and $400 in debentures for each share of old stock. The accumulated earnings and profits of the corporation were considerably in excess of the debentures thus distributed. The principal questions presented are:

1. Whether the transaction constituted a "reorganization" within the meaning of Section 112 (g) (1) of the Internal Revenue Code, so as to exempt the receipt of the debentures from income tax. The answer to this question depends upon whether the Tax Court and the court below correctly held that a "reorganization" under the statute exists only where the transaction has a legitimate corporate business purpose, and whether the Tax Court's finding that there was no such purpose here was properly affirmed by the court below.

2. Whether, if it be held that there was not a statutory reorganization, the distribution of the debentures should be treated as an ordinary dividend under Sections 22 (a) and 115 of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set out in the Appendix, infra, pp. 36 to 50.

STATEMENT

The pertinent facts found by the Tax Court (R. 90–95) may be summarized as follows:

The taxpayer, a resident of Pottsville, Pennsylvania, is the president and treasurer of J. Robert Bazley, Inc., a Pennsylvania corporation (hereinafter referred to as "Corporation"), organized on May 1, 1930, with an authorized capital of 1,000 shares of a par value of $100 per share. On February 1, 1939, the taxpayer owned 798 shares, his wife, Alice H. Bazley, owned 201 shares, and one Alfred Day owned one share of the Corporation's 1,000 shares of outstanding stock. The three stockholders constituted the board of directors of the Corporation. (R. 90–91.)

The Corporation is engaged in a general heavy contracting business. Shortly prior to 1939 it was engaged almost entirely in mining coal by the open-pit method and then first considered going into road building work, which is financially hazardous and requires considerable working capital. Many road building contractors have failed. (R. 91.)

At a special meeting of the Corporation's directors on February 6, 1939, a plan of reorganiza-

tion was adopted and authority given to increase the capital stock of the Corporation as provided in the plan. The plan recited that on February 1, 1939, the capital of the Corporation was $100,000 and its earned surplus was $855,783.82. It provided for issuance, in exchange for the old stock, of 5,000 shares of new common stock of no par value but with a stated value of $300,000, and $400,000 principal amount of six per cent 20-year debenture bonds dated February 1, 1939, callable in whole or in part. The old stock was to be cancelled. The plan provided for reduction of the earned surplus to $255,782.82 as a result of the increased capitalization and issuance of debenture bonds. (R. 92–93.)

On February 16, 1939, the stockholders approved and authorized the proposed plan of reorganization, and on March 6, 1939, the Commonwealth of Pennsylvania approved the amendment to the Corporation's articles of incorporation providing for the increase of its stock. On March 16, 1939, the plan was carried out and the changes in capitalization were entered in the Corporation's books of account. As an incident thereof $400,000 of earned surplus was transferred to debenture bonds payable account. On March 16, 1939, the 5,000 shares of new stock had a fair market value of not less than $300,000 and the 20-year bonds had a fair market value of not less than $400,000, their face amount. (R. 93–94.)

The reasons for adopting the plan of recapitalization were that the stockholders, by obtaining debenture bonds for their stock would receive a more readily marketable and less fluctuating security, in case it was necessary for the estate of a deceased shareholder to liquidate his investment to meet inheritance tax or for other purposes; that if it became necessary for a stockholder to sell some portion of his investment, the bonds could be sold without reducing the Bazley family's stock control of the Corporation; the contemplated entry into the hazardous business of road construction made it desirable for the stockholders to have "funds," so as to be in a position to share with general creditors to the extent of the debentures, if the business did not succeed; and since the value of the Corporation's plant and equipment ($719,782.41 as of April 30, 1939) was large in relation to its capitalization of $100,000, and since the equipment had been purchased by using funds acquired through accumulating $855,783.07 of earnings and profits, it was thought advisable to reflect a more permanent dedication of these earnings to corporate use, by reducing the surplus available for dividends and transferring a part thereof to capital stock and a part to long-term debt represented by the 20-year debentures. (R. 91–92.)

The Tax Court explicitly found that "There was no legitimate purpose of the corporate busi-

ness of J. Robert Bazley, Inc., in the issuance and distribution to the stockholders of $400,000 in debenture bonds." (R. 95.)

The taxpayer, who originally held 798 shares of old stock, received 3,990 shares of new stock and debenture bonds in the principal amount of $319,200 upon consummation of the plan. (R. 94.) In his notice of deficiency for 1939, the Commissioner included in the taxpayer's income the amount of $319,200, representing the fair market value of the debentures thus received. (R. 95.)

The Tax Court held that, in the absence of a legitimate corporate reason for recapitalizing the Corporation to issue debentures, the distribution of the debentures was not pursuant to a reorganization, as defined by statute; that the distribution was essentially equivalent to the distribution of a taxable dividend, and is taxable as a dividend. (R. 96–102.) Five judges dissented. (R. 102–104.)

The Circuit Court of Appeals, sitting *en banc*, affirmed (R. 126–136), two judges dissenting (R. 137–140).

SUMMARY OF ARGUMENT

I

The Bazley corporation had over $800,000 in accumulated earnings and profits. As part of the transaction involved, $400,000 was subtracted

from its earnings and profits account, and debentures in a like amount were distributed to its stockholders. The taxpayer-stockholder herein seeks to avoid all tax with respect to that distribution on the ground that the transaction as a whole constituted a tax-free corporate reorganization under Section 112 (g) (1) of the Internal Revenue Code.

However, the Treasury Regulations restrict the reorganization provisions to transactions undertaken to promote the interests of the corporation, as such. Section 19.112 (g) (2) of Regulations 103 provides that the transaction "must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization". The reorganization provisions are not applicable to a transaction designed solely for the benefit of the stockholders. The result stated in the Regulations is supported by the legislative history and the decisions of the courts. The court below correctly sustained the Regulations as a "valid exercise of the rule making power." (R. 135.)

Further, the record amply supports the determination of the Tax Court that the facts of this case fail to bring it within the reorganization provisions as interpreted by the Regulations. The Tax Court explicitly found that "there was no legitimate purpose of the corporate business of J. Robert Bazley, Inc., in the issuance and

distribution to the stockholders of $100,000 in debenture bonds" (R. 95). The tax Court examined each of the alleged objectives behind the distribution of these debentures, and concluded that no one of them in fact constituted a *corporate* business purpose, although most of them were in the interests of the stockholders as individuals. All of the reasons advanced for the distribution of the debentures are consistent with the dominant purpose to pay a disguised dividend. And the court below properly affirmed the Tax Court when it found that the record supported the Tax Court's finding. It plainly stated that "To reverse the Tax Court in this case, we would have to hold the Treasury Regulations invalid" (R. 135).

II

The taxpayer makes an alternative argument that even if the transaction did not constitute a "reorganization", the distribution of the debentures did not constitute a taxable dividend, but should be regarded as part of the "exchange" whereby he surrendered his old stock and received new stock and debentures. If the transaction were thus to be treated as an "exchange" (under Section 112(c)(1)), only the excess of the value of the debentures over the basis of the proportionate amount of old stock would be taxable, and the amount of tax would be further limited by the capital gains provisions in Section 117.

The short answer to this contention is that the distribution of the debentures constitutes a dividend under Section 115 (a) and (g), regardless of the form of the distribution, whether it involves an "exchange" or takes some other form. Section 115 (a) defines a dividend as any distribution made out of earnings or profits accumulated after February 28, 1913, and Section 115 (g) deals with transactions which are the substantial equivalent of dividends, where "a corporation cancels or redeems its stock * * * at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend * * *." The debenture distribution here involved is within the letter and spirit of Section 115. Although there was no formal declaration of a dividend, none is required under these provisions.

ARGUMENT

INTRODUCTION

The instant case presents a situation where a corporation, having a capital stock of $100,000, divided into 1,000 shares of the par value of $100 each, all being outstanding, and an earned surplus of some $800,000, changed its structure so as to have 5,000 shares of no-par value stock with a stated value of $60 per share, making a total of $300,000; debenture bonds aggregating $400,-

000 in principal amount and surplus of some $200,000. The new stock and debentures were issued in the ratio of five new shares and $400 face amount of debentures for each old share. The stockholders, viewing the transaction as a tax-free "reorganization," reported no gain. The Commissioner determined that the debentures constituted income in their face amount and assessed a deficiency accordingly.

The Tax Court sustained the Commissioner. It ruled that the absence of a legitimate corporate purpose prevented the transaction from qualifying as a reorganization under the statute, and that there was in fact no such purpose in the issuance and distribution of the debentures to the stockholders in this case. It said that the individual stockholders may well have endeavored to establish a foundation for participating in the corporate profits without subjecting the distributions to taxation as dividends (R. 102). It therefore held that there was not a statutory reorganization and also held that the debenture distribution was the substantial equivalent of a taxable dividend. Five judges dissented in the Tax Court.

The Circuit Court of Appeals, sitting *en banc*, affirmed, two judges dissenting; it held that the transaction clearly had the effect of a taxable dividend and that whatever the motives of the taxpayer may have been, he was taxable on the bonds received to the extent of their face value.

Two principal questions are thus presented: (1) whether the transaction constitutes a tax-free "reorganization"; and (2) whether, in the event that the first question is answered in the negative, the receipt of the debentures contitutes a taxable dividend.

I

THE TRANSACTION DOES NOT QUALIFY AS A STATUTORY REORGANIZATION SINCE IT WAS NOT ACTUATED BY A PURPOSE GERMANE TO THE COMPANY'S BUSINESS

The Treasury Regulations provide that the casting of a transaction in the form of a reorganization is not sufficient to render it a tax-free reorganization under the statute. Section 19.112 (g)-1 of Regulations 103 (Appendix, *infra*) provides not only that the precise specifications of the reorganization provisions of the law must be satisfied, but that their underlying assumptions must also be met. It specifies that "an ordinary dividend is to be treated as an ordinary dividend * * * even though the mechanics of a reorganization have been set up." Section 19.112 (g)-2 (Appendix, *infra*) states one of the underlying assumptions to be that the transaction "must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization."

The Regulations thus reduce the area of possible conflict between the taxing provisions of the statute and the exemption provisions and,

under the specific terms of the Regulations, an ordinary dividend is taxable notwithstanding that it occurs in a transaction which is in the form of a reorganization. We think that the only question open to review in this connection is whether the Regulations are valid, and we think that they are valid because they reflect an understanding of the statute which has the approval of both the Congress and the courts. Of course, there is a subsidiary question whether the regulations were properly applied to the facts of this case; but since the record supports the Tax Court's finding that there was "no legitimate purpose of the corporate business" in the distribution of the debentures (R. 55), its determination should not be upset on appeal.

The language of the Regulations above quoted was first incorporated in the Regulations under the Revenue Act of 1934 (Treasury Regulations 86, Articles 112 (g)–1 and 112 (g)–2), and as the court below observed (R. 134), the Regulations have remained unchanged in this respect with the passage of succeeding Revenue Acts. The reenactment of the statute as thus construed by the Regulations must, under familiar principles, be regarded as having the approval of Congress. *Helvering* v. *Winmill*, 305 U. S. 79; *Taft* v. *Commissioner*, 304 U. S. 351. The lower court approved these Regulations as reasonable, and a valid exercise of the rule-making power. As it

stated, it would have had to hold the Regulations invalid, in order to reverse the Tax Court, since the recapitalization was not dictated by business exigencies of the corporation, nor was it germane to continuance of the corporate business. (R. 135.) The validity of the Regulations is supported not only by the legislative history of the statutory provisions, but also by the decisions of this Court and the lower courts applying these provisions.

House Report No. 179, 68th Cong., 1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 241, 251) and Senate Report No. 398, 68th Cong., 1st Sess., pp. 14–15 (1939–1 Cum. Bull. (Part 2) 266, 277) stated in reporting the Revenue Bill of 1924, that the Congressional policy was to exempt from tax the gain on reorganization exchanges so that "ordinary business transactions will not be prevented on account of the provisions of the tax law." Again, in connection with the Revenue Bill of 1934, House Report No. 704, 73d Cong., 2d Sess., p. 14 (1939–1 Cum. Bull. (Part 2) 554, 564) stated that—

> * * * the definition of a reorganization has been restricted so that the definition will conform more closely to the general requirements of corporation law, and will limit reorganizations to (1) statutory mergers and consolidations; (2) transfers to a controlled corporation, "control" being defined as an 80-percent ownership; and

(3) changes in the capital structure or form of organization.

By these limitations the committee believes that it has removed the danger that taxable sales can be cast into the form of a reorganization, while at the same time *legitimate reorganizations, required in order to strengthen the financial condition of the corporation, will be permitted.* Furthermore, the retention of the other reorganization provisions will prevent large losses from being established by bondholders and stockholders who receive securities in a newly reorganized enterprise which are substantially the same as their original investments. [Italics supplied.]

Senate Report No. 558, 73d Cong., 2d Sess., p. 17 (1939–1 Cum. Bull. (Part 2) 586, 599), is consistent. As the court below pointed out (fn. 12, R. 133), the statutory reorganization and exchange provisions were amended and retained in the 1934 Act, instead of being abolished as a result of attempted abuses, largely because the courts had shown a commendable tendency to look through form to substance, and the amendments were designed to give Congressional approval to such decisions and generally to curtail tax avoidance. See for a full discussion H. Rep. No. 704, 73d Cong., 2d Sess., pp. 12–14 (1939–1 Cum. Bull. (Part 2), 554, 563–565).

A similar restriction was put upon the scope of the reorganization provisions by this Court in

Gregory v. *Helvering*, 293 U. S. 465. In that case a corporation wholly owned by the taxpayer transferred 1,000 shares of stock in another corporation held by it among its assets to a new corporation, which thereupon issued all of its shares to the taxpayer. Within a few days the new corporation was dissolved and was liquidated by the distribution of the 1,000 shares to the taxpayer, who immediately sold them for her individual profit. No other business was transacted, or intended to be transacted, by the new corporation. The whole plan was designed to conform to Section 112 of the Revenue Act of 1928 as a "reorganization," but for the sole purpose of transferring the shares in question to the taxpayer, with a resulting tax liability less than that which would have ensued from a direct transfer by way of dividend. The Court held that while the plan literally conformed to the terms of the statute, there was no reorganization within the intent of the statute. In so holding, this Court took the view that the question for determination was whether what was done, apart from the tax motive, was within the statutory purpose. And in resolving that question in favor of the Commissioner, the Court said (pp. 469–470):

> When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" [Sec. 112 (g)] of corporate business; and not a transfer

of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having *no business or corporate purpose*—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax

> avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. [Italics supplied.]

As we read the opinion, it holds that whatever may be the tax motive back of a transaction, still, the reorganization provisions of the statute were intended to embrace only operations having a business or corporate purpose and since the *Gregory* transaction showed on its face that there was no such purpose, it was without the intent of the statute.

The *Gregory* case would clearly justify administrative officers in adopting the rule that in order to qualify as a reorganization for tax purposes, a transaction must be induced by a corporate business purpose as distinguished from one to benefit the stockholders individually. And see Paul, *Studies in Federal Taxation*, 3d Series (1940), p. 127; Montgomery, *Federal Taxes on Corporations, Gross Income and Deductions* (1942–1943), p. 218; Fahey, *Income Tax Definition of "Reorganization"*, 39 Col. L. Rev. 933, 937, 969 (1939). Subsequent decisions of this Court are in harmony with that view. Cf. *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609, 613–614; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Higgins* v. *Smith*, 308 U. S.

473, 476; *Helvering* v. *Limestone Co.*, 315 U. S. 179, 184–185.

It is true that in *John Kelley Co.* v. *Commissioner*, 326 U. S. 521, the Court, in upholding the Tax Court's conclusion that certain debentures should be treated as such for purposes of the interest deduction, indicated (pp. 525–526) that the *Gregory* case did not prevent that result because the debentures were real and could have been transferred to persons other than stockholders. But here no such question is presented; the issue is not whether the debentures should be accorded full significance as such for purposes of the interest deduction, but whether the reorganization provisions of the law can be brought into operation by a transaction which was the practical equivalent of an ordinary dividend. We submit that they cannot.

The decisions of the circuit courts of appeals sustain the contention that there must be a genuine corporate business purpose. *Electrical Securities Corp.* v. *Commissioner*, 92 F. 2d 593 (C. C. A. 2d); *Helvering* v. *Elkhorn Coal Co.*, 95 F. 2d 732 (C. C. A. 4th), certiorari denied, 305 U. S. 605; *Cogan* v. *Commissioner*, 97 F. 2d 996 (C. C. A. 2d), affirming, *per curiam*, 36 B. T. A. 639; *Black, Starr & Frost-Gorham* v. *United States*, 39 F. Supp. 109 (C. Cls.); *Hendee* v. *Commissioner*, 98 F. 2d 934 (C. C. A. 7th). In cases where it has been found that a statutory re-

organization occurred, the facts indicate that there was a corporate business purpose and the decisions are consistent with our position here. *Okonite Co.* v. *Commissioner*, 155 F. 2d 248 (C. C. A. 3d), certiorari denied, October 28, 1946; *Thermoid Co.* v. *Commissioner*, 155 F. 2d 589 (C. C. A. 3d); *Commissioner* v. *Capento Securities Corp.*, 140 F. 2d 382 (C. C. A. 1st); *Commissioner* v. *Gilmore's Estate*, 130 F. 2d 791 (C. C. A. 3d); *Bass* v. *Commissioner*, 129 F. 2d 300 (C. C. A. 1st); *Commissioner* v. *Kolb*, 100 F. 2d 920 (C. C. A. 9th); *Lea* v. *Commissioner*, 96 F. 2d 55 (C. C. A. 2d); *Coca-Cola Co.* v. *United States*, 47 F. Supp. 109 (C. Cls.); *J. R. Wood & Sons, Inc.* v. *United States*, 46 F. Supp. 277 (C. Cls.).

The Tax Court decisions are also in harmony with our contention. See opinion in the instant case (R. 96–102); also opinion in *Adams* case (*Adams* v. *Commissioner*, 5 T. C. 351, affirmed, 155 F. 2d 246 (C. C. A. 3d), certiorari granted, October 14, 1946, No. 209, present Term, to be argued herewith (*Adams* R. 101–109); *Wellhouse* v. *Commissioner*, 3 T. C. 363; *Annis Furs, Inc.* v. *Commissioner*, 2 T. C. 1096; *Schoo* v. *Commissioner*, 47 B. T. A. 459; *Docherty* v. *Commissioner*, 47 B. T. A. 462; *Fischer* v. *Commissioner*, 46 B. T. A. 999; *Bass* v. *Commissioner*, 45 B. T. A. 1117, reversed, 129 F. 2d 300 (C. C. A. 1st); *Capento Securities Corp.* v. *Commissioner*, 47 B. T. A. 691, affirmed, 140 F. 2d 382.

(C. C. A. 1st); *Hendy* v. *Commissioner*, decided July 24, 1945 (1945 P-H T. C. Memorandum Decisions, par. 45,261), pending on appeal (C. C. A. 7th).

If the principle thus embedded in the Regulations is a valid reflection of the purpose of Congress, then the only remaining question with respect to the application of the reorganization provision is whether the facts of this case disclose a purpose which is germane to the continuance of the business of the corporation or a purpose to promote the individual interests of the stockholders. With respect to such a question the scope of appellate review is limited to whether there is any evidence to support the decision of the Tax Court. *Wilmington Trust Co.* v. *Helvering*, 316 U. S. 164; *Helvering* v. *National Grocery Co.*, 304 U. S. 282, rehearing denied, 305 U. S. 669. The same rule is applied in cases dealing with the question whether transfers were made in contemplation of death. The motive is the critical question in such cases and it has long been the rule that the only question open in the appellate courts is whether there was substantial, or any, evidence to support the decision of the trial court. *McCaughn* v. *Real Estate Co.*, 297 U. S. 606; *Allen* v. *Trust Co. of Georgia*, 326 U. S. 630.

At any rate, it seems clear that since *Dobson* v. *Commissioner*, 320 U. S. 489, this is precisely the kind of question upon which the determina-

tion of the Tax Court is to be final. At this point we are assuming that the principle is settled and that the question is narrowed to whether the facts of this particular case bring it within the principle. The resolution of that question will decide only whether the taxpayer has sustained the burden of proof. *Welch* v. *Helvering*, 290 U. S. 111, 115. Therefore, under the *Dobson* decision, the Tax Court's determination should be accepted as conclusive unless it is arbitrary or unreasonable. *John Kelley Co.* v. *Commissioner*, 326 U. S. 521.

In the instant case the Tax Court specifically found that there was no legitimate corporate business purpose in the distribution of the debentures (R. 95), and its opinion reiterated its findings that there was "a complete absence of legitimate corporate business purpose within the *Gregory* principle" (R. 101). We submit that there is nothing arbitrary or unreasonable about those findings and the Circuit Court of Appeals rightly upheld them. The reasons for the recapitalization are discussed in detail in the findings and opinion of the Tax Court (R. 91–92, 96, 99–101), the opinion of the Circuit Court of Appeals (R. 134–135), and in our brief in opposition to the petition for certiorari (pp. 8–9); and it seems unnecessary to discuss them further here. They do not disclose any purpose germane to the company's business and are consistent with the Tax

Court's factual conclusion, discussed more fully hereinafter, that the bond distribution was in fact a dividend or the substantial equivalent thereof.

The test contended for is not so vague and unworkable as the taxpayer appears to suggest. For example, in *Commissioner* v. *Capento Securities Corp., supra,* the recapitalization was consummated because a bank stipulated it as a condition on which it would extend credit. In *Commissioner* v. *Gilmore's Estate,* 130 F. 2d 791 (C. C. A. 3d), one of the corporate business objectives was the elimination of a holding company. In some cases the corporation desired to obtain stock which it could market (*Bass* v. *Commissioner, supra; Starr* v. *Commissioner,* 82 F. 2d 964 (C. C. A. 4th), certiorari denied, 298 U. S. 680; *Fischer* v. *Commissioner, supra; Haass* v. *Commissioner,* 29 B. T. A. 900, affirmed without opinion, January 14, 1936 (C. C. A. 6th)), and in others the purpose was to eliminate unpaid accumulated dividends on preferred stock so as to improve the corporation's financial standing (*Commissioner* v. *Estate of Bedford,* 325 U. S. 283; *Okonite Co.* v. *Commissioner, supra; Thermoid Co.* v. *Commissioner, supra; Morainville* v. *Commissioner,* 135 F. 2d 201 (C. C. A. 6th); *Shenandoa Rayon Corp.* v. *Commissioner,* 122 F. 2d 268 (C. C. A. 2d), certiorari denied, 314 U. S. 696)). In the *Okonite* case the court distinguished its earlier decision in the instant case by pointing out that the finding of the Tax Court

as to elimination of dividend arrears shows a statement of corporate purpose.

Moreover, it is settled that the mere difficulty in making a finding does not obviate the necessity therefor or the significance of the finding when made. *Helvering* v. *Safe Deposit Co.*, 316 U. S. 56, 66–67; *Cohan* v. *Commissioner*, 39 F. 2d 540, 543–544 (C. C. A. 2d).

The dissenting opinion in the court below (R. 137–140) seems to turn largely upon the difficulty of separating the interests of the corporation from those of its stockholders. But the transaction in the *Gregory* case was certainly intended to be in the stockholder's interest; indeed such was its prime objective; yet the Court held the statute inapplicable because there was no legitimate corporate purpose. While it is true that the general object of a business corporation is to make money for its stockholders, who are in a sense joint adventurers (Berle, *Studies in the Law of Corporation Finance* (1928), p. 20), still, it is also true that there may be a marked conflict of interest as where a stockholder "may hold a large block of stock of the X corporation, and may nevertheless work toward the wreck of the X corporation for some private object of his own." Berle, op. cit., p. 24. In any event, the instant case is not one which it is difficult to classify under the corporate business purpose test. This case hinges simply upon whether the

debenture distribution was in reality a disguised dividend intended solely for the benefit of the stockholders as such and having no connection with the regular business of the company. It is essentially a *Gregory* situation though consummated without the interposition of a new company.

Although the declaration of dividends is an important corporate function, and indeed corporations in some circumstances have been penalized for not exercising it (*Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282), nevertheless, it is certainly not part of the legitimate corporate business to disguise dividends as was done here. If the instant transaction were motivated by such a purpose, and the courts below evidently thought it was, then it would clearly be contrary to the Congressional intention to hold that there was a tax-free reorganization. In any event, we submit that the taxpayer did not sustain the burden of proving such a corporate business purpose as was required to bring the reorganization provisions into operation, and both of the courts below correctly so held.

II

THE DISTRIBUTION OF DEBENTURE BONDS WAS PROPERLY TAXED AS A DIVIDEND

Section 22 (a) of the Internal Revenue Code (Appendix, *infra*) defines in broad and comprehensive terms the income which the taxpayer

must report as his gross income. That income includes "gains, profits, and income * * * growing out of the ownership or use of or interest in such property" or derived "from interest, rent, dividends, securities * * *, or gains or profits and income derived from any source whatever."

Section 115 of the Internal Revenue Code (Appendix, *infra*) covers distributions by corporations. It provides in subdivision (a) that the term "dividend" means any distribution made by a corporation to its stockholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, ~~1913~~ 1913. And in subdivision (b) it is provided that for the purposes of the law every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Subdivision (g) of Section 115 provides that if a corporation cancels or redeems its stock at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend. Subdivision (j) provides that where a dividend is paid in any medium other than money the property received shall be included in gross income at its fair market value.

It seems clear that the debenture distribution involved in the instant case falls squarely within the scope of the statutory provisions above noted. Admittedly, there were earnings and profits accumulated since the organization of the company in 1930 in excess of the fair market value of the debentures. Moreover, we do not understand it to be questioned that if a dividend of the debentures had formally been declared, the amount thereof would have been taxable in the same manner as if paid in cash. *Doerschuck* v. *United States*, 274 Fed. 739 (E. D. N. Y.).

In the circumstances, it is of little importance whether the distribution fell within the scope of subdivision (a) rather than (g). True, there was no formal declaration of a dividend, and the entire transaction was given the form of a reorganization under Section 112 (b) (3) and (g) of the Internal Revenue Code (Appendix, *infra*). But it is settled that it is unnecessary for a dividend to be formally declared in order to be treated as such for tax purposes. Indeed, this Court in effect so held in *Commissioner* v. *Estate of Bedford*, 325 U. S. 283, discussed *infra*, pp. 31–32. See also *Palmer* v. *Commissioner*, 302 U. S. 63, 69; *Chattanooga Sav. Bank* v. *Brewer*, 17 F. 2d 79 (C. C. A. 6th), certiorari denied, 274 U. S. 751; *Hadley* v. *Commissioner*, 36 F. 2d 543 (App. D. C.); *Christopher* v. *Burnet*, 55 F. 2d 527 (App. D. C.); *Fitch* v. *Helvering*, 70 F. 2d 583 (C. C. A. 8th);

Faris v. *Helvering*, 71 F. 2d 610 (C. C. A. 9th), certiorari denied, 293 U. S. 584; *Timberlake* v. *Commissioner*, 132 F. 2d 259 (C. C. A. 4th); *Regensburg* v. *Commissioner*, 144 F. 2d 41 (C. C. A. 2d), certiorari denied, 323 U. S. 783; *Paramount-Richards Th.* v. *Commissioner*, 153 F. 2d 602 (C. C. A. 5th).

Most of the foregoing cases were decided under subdivision (a) or its equivalent in the earlier tax laws, but the rule is the same with respect to subdivision (g). And although there has been some difference of opinion as to the exact basis for the operation of subdivision (g) (see *Kirschenbaum* v. *Commissioner*, 155 F. 2d 23 (C. C. A. 2d), certiorari denied, October 14, 1946; *DeNobili Cigar Co.* v. *Commissioner*, 1 T. C. 673, 678–679, affirmed, 143 F. 2d 436 (C. C. A. 2d)), nevertheless the courts have generally held that the question whether a distribution is essentially equivalent to a taxable dividend is one of fact which depends upon the circumstances in each particular case. *Brown* v. *Commissioner*, 79 F. 2d 73 (C. C. A. 3d); *Commissioner* v. *Champion*, 78 F. 2d 513 (C. C. A. 6th); *Randolph* v. *Commissioner*, 76 F. 2d 472 (C. C. A. 8th); *Hirsch* v. *Commissioner*, 124 F. 2d 24 (C. C. A. 9th); *Commissioner* v. *Babson*, 70 F. 2d 304 (C. C. A. 7th). The Treasury Regulations are in harmony with that view and have long provided that the question whether a distribution in connection with a cancellation or redemption of stock is essen-

tially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. Sec. 19.115–9, Treasury Regulations 103, Appendix, *infra*; Article 115–9, Treasury Regulations 101, 94, and 86. And the latest regulations continue so to provide. See, Section 29.115–9, Treasury Regulations 111.

The objective of Congress is shown by the illustration in the Congressional Committee Reports with respect to Section 201 (g) of the Revenue Act of 1926, in which the provision first came into the law. H. Conference Rep. No. 356, 69th Cong., 1st Sess., p. 30 (1939–1 Cum. Bull. (Part 2) 361), reads in part as follows (pp. 361–362):

> Amendment No. 1: It has been contended that under existing law a corporation, especially one which has only a few stockholders, might without resorting to the device of a stock dividend be able to make a distribution to its stockholders which would have the same effect as a taxable dividend. For example, assume that two men hold practically all the stock of a corporation for which each had paid $50,000 in cash, and the corporation had accumulated a surplus of $50,000 above its cash capital. It is claimed that under existing law the corporation could buy from the stockholders for cash one-half of the stock held by them and cancel it without making the stockholders subject to any tax, yet this action in

> all essentials would be the equivalent of a distribution through cash dividends of the earned surplus. Section 201 (g) of the House bill rewrites the provision of the existing law to make clear that such a transaction as above indicated is taxable. Obviously this subdivision does not apply in cases of a complete liquidation of all the stock of the corporation, or to one of a series of distributions in a complete liquidation which is bona fide carried out. This amendment provides that in the case of the cancellation or redemption of stock not issued as a stock dividend this subdivision shall apply only if the cancellation or redemption is made after January 1, 1926; and the House recedes.

See also H. Rep. No. 1, 69th Cong., 1st Sess., p. 5 (1939-1 Cum. Bull. (Part 2) 315, 318); S. Rep. No. 52, 69th Cong., 1st Sess., p. 15 (1939-1 Cum. Bull. (Part 2) 332, 344). We submit that the Circuit Court of Appeals correctly held the instant situation to be within the scope of that illustration. (R. 129–131.)

One of the leading cases is *Flanagan* v. *Helvering*, 116 F. 2d 937 (App. D. C.), where the court pointed out (p. 939) that in determining whether a transaction is equivalent to a taxable dividend under Section 115 (g), there is no sole decisive test; the phrases "in such manner" and "essentially equivalent" negative any idea that a weighted formula can resolve the crucial issue. The court said (pp. 939–940) that

> * * * the net effect of the distribution rather than the motives and plans of the taxpayer or his corporation, is the fundamental question in administering Section 115 (g).

In the circumstances, the court concluded that the Board of Tax Appeals made no error in its determination that the redemption payment was essentially equivalent to the distribution of a taxable dividend. Cf. also *McGuire* v. *Commissioner*, 84 F. 2d 431 (C. C. A. 7th), certiorari denied, 299 U. S. 591; *Smith* v. *United States*, 121 F. 2d 692 (C. C. A. 3d).

As already noted, the Tax Court in the instant case concluded that the debenture distribution was "the equivalent of the declaration of a taxable dividend" (R. 99), and the Circuit Court of Appeals upheld that factual conclusion (R. 129). In the circumstances, we submit that the appellate court could not properly have done anything else, for the record plainly shows that the distribution was made out of earned surplus. *Edwards* v. *Douglas*, 269 U. S. 204, 216–217; *Helvering* v. *Canfield*, 291 U. S. 163; *Beretta* v. *Commissioner*, 141 F. 2d 452 (C. C. A. 5th), certiorari denied, 323 U. S. 720; *Wilcox* v. *Commissioner*, 137 F. 2d 136, 139 (C. C. A. 9th). There was no liquidation here as there was in *Hellmich* v. *Hellman*, 276 U. S. 233. Here the corporation was a going concern and its capitalization was expanded by transfers from surplus.

And to the extent that the case can thus be reduced to its particular circumstances rather than turn upon a generalizing principle, it would seem that *Dobson* v. *Commissioner*, 320 U. S. 489, is here applicable. Cf. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283, 292.

The net effect of the whole transaction here involved was to leave the shareholders in exactly the same position that they would have been in if the debentures had been distributed in the form of a dividend instead of in the form of a reorganization. It seems clear that, as held by the Circuit Court of Appeals in this case, whatever may have been the motives of the Bazleys, the effect of the distribution was that of a dividend. And cf. *Dutton* v. *Clauson* (D. Maine), decided September 27, 1946 (1946 C. C. H., par. 9354). If the face amount of the debentures had been paid in cash to the stockholders and they had then turned it back to the corporation as payment for debentures which had been issued, there would be no question as to taxability. *Doerschuck* v. *United States*, *supra*. And even assuming, *arguendo*, that there was a real reorganization so far as the exchange of stock is concerned, still, in the circumstances the debentures would have been taxable as a dividend under *Commissioner* v. *Estate of Bedford*, *supra*. There a distribution of cash out of earnings and profits of a corporation, pursuant to a recapitalization which amounted to a statu-

tory reorganization, was held by this Court to have had the effect of the distribution of a taxable dividend within the meaning of Section 112 (c) (2) of the Revenue Act of 1936, which is the same as Section 112 (c)(2) of the Internal Revenue Code (Appendix, *infra*), and to be taxable in full under that section and not as a capital gain under Section 112 (c) (1). We submit that there is not enough difference between that case and the instant one to justify a different result.

Moreover, the *Bedford* case is a complete answer to the taxpayer's contention (Br. 23 ff.) that even if there were no statutory reorganization so that the receipt of the debentures would be tax-free, the income realized on receipt of the debentures must be taxed as a capital gain rather than as a dividend because they were received in an exchange. But even assuming that there were an exchange, that would not prevent the courts from looking through form to substance so as to determine whether a dividend was in fact involved. That, as we understand it, is the rationale of the *Bedford* case and it is also the plain intent of the statute. The decisions of the courts below are in harmony with that view.

There are many instances in the law where it has been necessary to look through form to substance in deciding tax cases. The rationale of such cases is perhaps expressed by the language in *Minnesota Tea Co.* v. *Helvering*, 302 U. S.

609, 613, as follows: "A given result at the end of a straight path is not made a different result because reached by following a devious path."[1] In the instant case the result at the end of a straight path unquestionably would have been an ordinary dividend; and we submit that the result is not changed because a different path was followed.

We are not here contending that the plan of recapitalization should be disregarded, or that the securities issued in pursuance of it are unreal or not valid in accordance with their tenor. Cf. *John Kelley Co.* v. *Commissioner*, 326 U. S. 521. But we do contend that the distribution of debentures under the plan was substantially equivalent to a taxable dividend, and both the courts below correctly so held.

Taxpayer's reliance upon Sections 112 (b) (2) and (c) (1) of the Internal Revenue Code (Appendix, *infra*) is misplaced. He contends in substance that there was an "exchange" of his old stock for new stock and debentures, and that the only possible taxable gain is a capital gain measured by the excess of the value of the debentures over the basis of a proportionate amount

[1] See also *Helvering* v. *Clifford*, 309 U. S. 331; *Higgins* v. *Smith*, 308 U. S. 473; *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; *Commissioner* v. *Tower*, 327 U. S. 280; *Lusthaus* v. *Commissioner*, 327 U. S. 293; *Corliss* v. *Bowers*, 281 U. S. 376, 378; *Griffiths* v. *Commissioner*, 308 U. S. 355, 357; *Harrison* v. *Schaffner*, 312 U. S. 579, 581.

of his old stock. (Br. 23 ff.) The crux of his argument is the fact that the Tax Court employed the word "exchange" in describing the transaction, and he therefore seeks to bring this case within the provisions of Section 112 (b) (2) and (c) (1). The fallacy of this position, however, is that the provisions of Section 115 (a) and (g) undercut the provisions of Section 112 (b) (2) and (c) (1). Section 115 (g) speaks of a redemption of stock in such manner as to render the transaction the equivalent to the distribution of a taxable dividend. Obviously such transaction may consist of an "exchange" of securities, and, unless Section 115 (g) be held applicable in such circumstances, its provisions could be nullified. For, every corporation could, in the guise of a recapitalization similar to the one here, distribute its earnings and profits in the form of bonds or other property to its stockholders, who would be taxed on the bonds or other property merely to the extent that they reflect capital gains. This would mean that all the earnings could be distributed in such a manner and thus escape taxation as dividends. It seems clear that Section 115 (a) and (g) must be read as a gloss upon Section 112 (c) (1) to require the taxation as dividends of distributions which are in substance dividends.

The taxpayer cities no authority compelling the holding that a distribution which is in substance a dividend as defined in Section 115 (a)

cannot be so treated under Section 115 (g) merely because it is made in the form of an exchange. Cf. *Commissioner* v. *Estate of Bedford, supra.* Section 115 (g) is obviously not so restricted that it cannot apply to a distribution of property in cancellation of old stock where the distribution is cast in the form of an exchange. The section applies to any cancellation of stock made under such circumstances as to be the equivalent of a dividend. It is not confined to such cancellations as fall within the statutory definition of a partial liquidation. It is immaterial under Section 115 (g) that simultaneously with the cancellation of the old stock a different class of stock was issued. *Hill* v. *Commissioner,* 66 F. 2d 45 (C. C. A. 4th).

CONCLUSION

The judgment of the court below should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U. S. C. 1940 ed., Sec. 22.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * * *

(2) *Stock for Stock of Same Corporation.*—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(3) *Stock for Stock on Reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of

the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(c) *Gain From Exchanges Not Solely in Kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

* * * * *

(g) [as amended by Section 213 (b) of the Revenue Act of 1939, c. 247, 53 Stat. 862]. *Definition of Reorganization.*—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected. (26 U. S. C. 1940 ed., Sec. 112.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(b) *Percentage Taken into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has

been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

* * * * * *

(f) *Retirement of Bonds, Etc.*—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

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(26 U. S. C. 1940 ed., Sec. 117.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 238, inclusive, and, in certain cases, by section 251, for citizens

and domestic corporations derive income from sources within possessions of the United States. Income may be in the form of cash or of property.

* * * * *

SEC. 19.112 (g)-1. *Purpose and scope of exception of reorganization exchanges.*—*Purpose:* Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. * * * In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and pur-

poses must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up..

* * * * * *

The provisions of the Internal Revenue Code referred to in the preceding paragraph of this section are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 112 (g) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization.

SEC. 19.112 (g)–2. *Definition of terms.*—

* * * * * * *

The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 112 (g) (1). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 112 (g) (1), but is to be taken as limiting the nonrecognition of gain or loss

to such exchanges as are directly a part of the transaction specifically described as a reorganization in section 112 (g) (1). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 112 (g) (1), but the readjustments involved in the exchanges effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 112 (g) (1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

* * * * *

SEC. 19.112 (g)-4. *Exchanges in reorganization for stock or securities and other property or money.*—If in an exchange of stock or securities in a corporation a party to a reorganization, in pursuance of the plan of reorganization, for stock or securities in the same corporation or in another corporation a party to the reorganization, there is received by the taxpayer other property (not permitted to be received without the recognition of gain) or money, then

(1) As provided in section 112 (c) (1), the gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of money and the fair market value of the other property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (c)).

* * * * *

If the distribution of such other property or money by or on behalf of a corporation in the course of a reorganization has the effect of the distribution of a taxable dividend, then, as provided in section 112 (c) (2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) as a gain from the exchange of property, the remainder of the gain so recognized.

* * * * *

SEC. 19.112 (g)–5. *Receipt of stock or securities in reorganization without surrender of stock by shareholder.*—Any distribution, though in pursuance of a plan of reorganization, to its shareholders without the surrender of their stock, by or on behalf of a corporation a party to a reorganization, of its stock or securities (other than its own stock, which is not taxable as a dividend under section 115 (f)) or of stock or securities of another corporation a party to the reorganization, shall be taxed to such shareholders as a dividend, within the meaning of section 115, to the extent that the fair market value of such stock or securities at the date of the distribution is not in excess of (1) the earnings or profits of the corporation of the taxable year computed without regard to prior years and (2) the earnings or profits of the corporation accumulated after February 28, 1913, and prior to the taxable year. Any remainder of such fair market value of the stock or securities distributed over the amount of such earnings

or profits shall be applied against and used to reduce the basis provided in section 113 of the stock in respect of which the distribution was made; and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

SEC. 19.115–8. *Election of shareholders as to medium of payment.*—If the shareholder has the right to an election or option with respect to whether a distribution shall be paid either (a) in money or any other property or (b) in stock or rights to acquire stock of a class which, if distributed without an election, would not constitute income within the meaning of the sixteenth amendment to the Constitution, then the entire distribution is a taxable dividend regardless of—

(1) whether the distribution is actually made, in whole or in part, in stock or in stock rights which, if distributed without election, would not constitute a taxable dividend;

(2) whether the election is exercised or exercisable before or after the declaration of the distribution; or

(3) whether the declaration of the dividend provides that payment will be made in one medium unless the shareholder specifically requests payment in the other. The term "any other property" as used in this section includes stock of the corporation or rights to acquire its stock, of a class which if distributed without an election, would constitute income within the meaning of the sixteenth amendment to the Constitution. (See section 19.115–7.)

SEC. 19.115–9. *Distribution in redemption or cancellation of stock taxable as a*

dividend.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in a complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the

corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

SEC. 19.115–10. *Dividends paid in property.*—If the whole or any part of the dividend is paid to a shareholder in any medium other than money, the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder. (See section 19.42–3.) Scrip dividends are subject to tax in the year in which the warrants are issued.

SEC. 19.115–11.—*Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—

* * * * *

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1939, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1939, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in section 112 (b) (6) of the Revenue Act of 1936, or of the Revenue Act of 1938, or of the Internal Revenue Code.

(3) The distribution in any taxable year (beginning after December 31, 1938) of stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as

dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a fax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

For the purpose of this section, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after Decemebr 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934; for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936; and for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938.

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SUPREME COURT OF THE UNITED STATES

Nos. 287 and 209.—October Term, 1946.

J. Robert Bazley, Petitioner, v. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.
Adam A. Adams, Petitioner, v. Commissioner of Internal Revenue.	On Writ of Certiorari to the Circuit Court of Appeals for the Third Circuit.

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[June 16, 1947.]

Mr. Justice Frankfurter delivered the opinion of the Court.

The proper construction of provisions of the Internal Revenue Code relating to corporate reorganizations is involved in both these cases. Their importance to the Treasury as well as to corporate enterprise led us to grant certiorari, 329 U. S. 695, 329 U. S. 701. While there are differences in detail to which we shall refer, the two cases may be disposed of in one opinion.

In the *Bazley* case, No. 287, the Commissioner of Internal Revenue assessed an income tax deficiency against the taxpayer for the year 1939. Its validity depends on the legal significance of the recapitalization in that year of a family corporation in which the taxpayer and his wife owned all but one of the Company's one thousand shares. These had a par value of $100. Under the plan of reorganization the taxpayer, his wife, and the holder of the additional share were to turn in their old shares and receive in exchange for each old share five new shares

of no par value, but of a stated value of $60, and new debenture bonds, having a total face value of $400,000, payable in ten years but callable at any time. Accordingly, the taxpayer received 3,990 shares of the new stock for the 798 shares of his old holding and debentures in the amount of $319,200. At the time of these transactions the earned surplus of the corporation was $855,783.82.

The Commissioner charged to the taxpayer as income the full value of the debentures. The Tax Court affirmed the Commissioner's determination, against the taxpayer's contention that as a "recapitalization" the transaction was a tax-free "reorganization" and that the debentures were "securities in a corporation a party to a reorganization," "exchanged solely for stock or securities in such corporation" "in pursuance of a plan of reorganization," and as such no gain is recognized for income tax purposes. Internal Revenue Code, §§ 112 (g) (1) (E) and 112 (b) (3). The Tax Court found that the recapitalization had "no legitimate corporate business purpose" and was therefore not a "reorganization" within the statute. The distribution of debentures, it concluded, was a disguised dividend, taxable as earned income under §§ 22 (a) and 115 (a) and (g). 4 T. C. 897. The Circuit Court of Appeals for the Third Circuit, sitting *en banc*, affirmed, two judges dissenting. 155 F. 2d 237.

Unless a transaction is a reorganization contemplated by § 112 (g), any exchange of "stock or securities" in connection with such transaction, cannot be "in pursuance of the plan of reorganization" under § 112 (b) (3). While § 112 (g) informs us that "reorganization" means, among other things, "a recapitalization," it does not inform us what "recapitalization" means. "Recapitalization" in connection with the income tax has been part of the revenue laws since 1924. 42 Stat. 227, 230, § 202 (c) (2). Congress has never defined it and the Treasury

Regulations shed only limited light. Treas. Reg. 103, § 19.112 (g). One thing is certain. Congress did not incorporate some technical concept, whether that of accountants or of other specialists, into § 112 (g), assuming that there is agreement among specialists as to the meaning of recapitalization. And so, recapitalization as used in § 112 (g) must draw its meaning from its function in that section. It is one of the forms of reorganization which obtains the privileges afforded by § 112 (g). Therefore, "recapitalization" must be construed with reference to the presuppositions and purpose of § 112 (g). It was not the purpose of the reorganization provision to exempt from payment of a tax what as a practical matter is realized gain. Normally, a distribution by a corporation, whatever form it takes, is a definite and rather unambiguous event. It furnishes the proper occasion for the determination and taxation of gain. But there are circumstances where a formal distribution, directly or through exchange of securities, represents merely a new form of the previous participation in an enterprise, involving no change of substance in the rights and relations of the interested parties one to another or to the corporate assets. As to these, Congress has said that they are not to be deemed significant occasions for determining taxable gain.

These considerations underlie § 112 (g) and they should dominate the scope to be given to the various sections, all of which converge toward a common purpose. Application of the language of such a revenue provision is not an exercise in framing abstract definitions. In a series of cases this Court has withheld the benefits of the reorganization provision in situations which might have satisfied provisions of the section treated as inert language, because they were not reorganizations of the kind with which § 112, in its purpose and particulars, concerns itself. See *Pinellas Ice and Cold Storage Co.* v.

Commissioner, 287 U. S. 462; *Gregory* v. *Helvering*, 293 U. S. 465; *Le Tulle* v. *Scofield*, 308 U. S. 415.

Congress has not attempted a definition of what is recapitalization and we shall follow its example. The search for relevant meaning is often satisfied not by a futile attempt at abstract definition but by pricking a line through concrete applications. Meaning frequently is built up by assured recognition of what does not come within a concept the content of which is in controversy. Since a recapitalization within the scope of § 112 is an aspect of reorganization, nothing can be a recapitalization for this purpose unless it partakes of those characteristics of a reorganization which underlie the purpose of Congress in postponing the tax liability.

No doubt there was a recapitalization of the Bazley corporation in the sense that the symbols that represented its capital were changed, so that the fiscal basis of its operations would appear very differently on its books. But the form of a transaction as reflected by correct corporate accounting opens questions as to the proper application of a taxing statute; it does not close them. Corporate accounting may represent that correspondence between change in the form of capital structure and essential identity in fact which is of the essence of a transaction relieved from taxation as a reorganization. What is controlling is that a new arrangement intrinsically partake of the elements of reorganization which underlie the Congressional exemption and not merely give the appearance of it to accomplish a distribution of earnings. In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity because cast in the form of a recapitalization-reorganization.

The governing legal rule can hardly be stated more narrowly. To attempt to do so would only challenge astuteness in evading it. And so it is hard to escape the conclusion that whether in a particular case a paper recapitalization is no more than an admissible attempt to avoid the consequences of an outright distribution of earnings turns on details of corporate affairs, judgment on which must be left to the Tax Court. See *Dobson* v. *Commissioner*, 320 U. S. 489.

What have we here? No doubt, if the Bazley corporation had issued the debentures to Bazley and his wife without any recapitalization, it would have made a taxable distribution. Instead, these debentures were issued as part of a family arrangement, the only additional ingredient being an unrelated modification of the capital account. The debentures were found to be worth at least their principal amount, and they were virtually cash because they were callable at the will of the corporation which in this case was the will of the taxpayer. One does not have to pursue the motives behind actions, even in the more ascertainable forms of purpose, to find, as did the Tax Court, that the whole arrangement took this form instead of an outright distribution of cash or debentures, because the latter would undoubtedly have been taxable income whereas what was done could, with a show of reason, claim the shelter of the immunity of a recapitalization-reorganization.

The Commissioner, the Tax Court and the Circuit Court of Appeals agree that nothing was accomplished that would not have been accomplished by an outright debenture dividend. And since we find no misconception of law on the part of the Tax Court and the Circuit Court of Appeals, whatever may have been their choice of phrasing, their application of the law to the facts of this case must stand. A "reorganization" which is merely a vehicle, however elaborate or elegant, for conveying earnings

from accumulations to the stockholders is not a reorganization under § 112. This disposes of the case as a matter of law, since the facts as found by the Tax Court bring them within it. ~~And the facts would equally sus-~~

"And even if this transaction were deemed a reorganization, the facts would equally sustain the imposition of the tax on the debentures under Sec. 112 (c) (1) and (2). *Commissioner* v. *Estate of Bedford*, 325 U. S. 283."

~~of gain, but also of other property, or money. . . ." *Commissioner v. Estate of Bedford*, 325 U. S. 283.~~

In the *Adams* case, No. 209, the taxpayer owned all but a few of the 5914 shares of stock outstanding out of an authorized 6000, par value $100. By a plan of reorganization, the authorized capital was reduced by half, to $295,700, divided into 5914 shares of no par value but having a stated value of $50 per share. The 5914 old shares were cancelled and the corporation issued in exchange therefor 5914 shares of the new no-par common stock and 6 per cent 20 year debenture bonds in the principal amount of $295,700. The exchange was made on the basis of one new share of stock and one $50 bond for each old share. The old capital account was debited in the sum of $591,400, a new no-par-capital account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. The corporation at this time had accumulated earnings available for distribution in a sum not less than $164,514.82, and this account was left unchanged. At the time of the exchange, the debentures had a value not less than $164,208.82.

The Commissioner determined an income tax deficiency by treating the debenture bonds as a distribution of the corporation's accumulated earnings. The Tax Court sustained the Commissioner's determination, 5 T. C. 351, and the Circuit Court of Appeals affirmed. 155 F. 2d 246. The case is governed by our treatment of the *Bazley*

case. The finding by the Tax Court that the reorganization had no purpose other than to achieve the distribution of the earnings, is unaffected by the bookkeeping detail of leaving the surplus account unaffected. See § 115 (b), and *Commissioner* v. *Wheeler*, 324 U. S. 542, 546.

Other claims raised have been considered but their rejection does not call for discussion.

Judgments affirmed.

MR. JUSTICE DOUGLAS and MR. JUSTICE BURTON dissent in both cases for the reasons stated in the joint dissent of Judges Maris and Goodrich in the court below. *Bazley* v. *Commissioner*, 155 F. 2d 237, 244.